

Public Service Commission of Wisconsin  
Direct Testimony of Mary Kettle  
Gas and Energy Division

Wisconsin Energy Corporation  
Docket 9400-YO-100

January 14, 2015

1 Q. Please state your name, business address, and occupation.

2 A. My name is Mary Kettle and my business address is 610 N. Whitney Way, Madison,  
3 Wisconsin. I am employed by the Public Service Commission of Wisconsin  
4 (Commission) as an auditor in the Gas and Energy Division.

5 Q. Please state your educational background and experience.

6 A. I graduated from the University of Wisconsin-Madison in 1983 with an MBA in  
7 Management. I have been employed as an auditor by the Commission since 1986. I was  
8 designated as a Certified Public Accountant by the state of Wisconsin in 1989. I have  
9 previously presented exhibits and testimony for electric, natural gas, water, and telephone  
10 utilities on several occasions.

11 Q. What is the purpose of your testimony in this proceeding?

12 A. The purpose of my testimony is to discuss what action, if any, should be taken by the  
13 Commission in this proceeding to address the growing balance of deferred costs on the  
14 balance sheet of Wisconsin Electric Power Company (WEPCO). Nearly all of the  
15 deferred costs on WEPCO's balance sheet are associated with electric operations. The  
16 majority of deferred costs related to WEPCO's electric operations are deferred  
17 transmission costs. Other significant electric utility deferrals are related to the electric  
18 conservation escrow and the Power the Future (PTF) escrow, as well as costs related to  
19 the Section 199 production tax deduction and MISO operations.

1 Q. Why do you believe that this proceeding is the appropriate venue in which to address this  
2 issue?

3 A. In order to address the issue of the growing balance of deferrals in the context of a rate  
4 case, at least one party or Commission staff would need to propose that the requested rate  
5 increase be made larger. It is unlikely that any party or Commission staff would propose  
6 that a requested rate increase be made larger because WEPCO's rates are already high.  
7 In docket 6630-CU-101, the docket for WEPCO's request to convert its Valley Power  
8 Plant from coal-fired to gas-fired generation, Commission staff witness John Feit  
9 presented testimony showing that WEPCO's industrial rates are the highest of the four  
10 largest Wisconsin investor-owned utilities (IOU), using 2012 data, and are 20 percent  
11 higher than WPSC's industrial rates. He also provided testimony showing that  
12 WEPCO's residential rates are higher than those of three of the other four major  
13 Wisconsin IOUs, using data for the first ten months of 2013, with only MGE's residential  
14 rates being higher.<sup>1</sup>

15 Q. What level of rate recovery has WEPCO requested with respect to its transmission costs  
16 in the past several years?

17 A. In docket 5-UR-106, for a 2013 test year, the company requested and the Commission  
18 agreed that test year transmission expense be set equal to the transmission recovery  
19 provided in its 2010 test year rate order of \$250.7 million. That level of transmission  
20 expense has been included in revenue requirement for 2013 and 2014, and was also  
21 included in revenue requirement in docket 5-UR-107 for 2015 and 2016. The company's

---

<sup>1</sup> Docket 6630-CU-101, John Feit surrebuttal testimony, pp. 1-3.

1 actual transmission costs were higher or are expected to be higher than the amount  
2 included in revenue requirement in each year of the 2013-2016 period.

3 Thus, neither Commission staff nor any of the parties has suggested that  
4 amortization periods should be shortened or that more of the estimated transmission costs  
5 should be reflected in revenue requirement in the last two rate proceedings. With  
6 WEPCO's electric rates already being relatively high, one may reasonably presume that  
7 no party would willingly put itself in the position of asking that the applicant's requested  
8 rate increase be made larger.

9 Q. How is WEPCO planning to address its growing balance of deferrals?

10 A. In response to a data request by Commission staff, WEC Energy Corporation (WEC or  
11 Applicant) declined to commit to a plan to amortize the estimated half-billion dollars it  
12 will have in deferrals by the end of 2016 for its electric utility, but indicated it was  
13 looking at a six- to eight-year period to amortize these costs.<sup>2</sup> Even if the company has  
14 no additional deferrals and it amortized its existing deferred balances over eight years, the  
15 company would need to amortize about \$60 million (or \$35 million net of tax) per year  
16 for eight years in order to eliminate the current deferred balance.

17 In addition, in the utility's most recent rate proceeding, docket 5-UR-107,  
18 Commission staff asked the utility how it planned to achieve competitive rates in the  
19 future with the deferrals it was proposing. The company responded by stating, "As for  
20 the deferrals referred to in the question, the alternative to deferring the identified  
21 prudently incurred costs for future recovery is to recover them more quickly. Given the  
22 continued slow pace of economic recovery, we believe deferral is the wiser course."<sup>3</sup>

---

<sup>2</sup> Data request PSCW-03.01, PSC REF#: 222050.

<sup>3</sup> Docket 5-UR-107, response to data request MK-2, dated 5/29/14, PSC REF#: 205381.

1 Q. Why is it important to address the growing balance of deferrals in this proceeding?

2 A. It is important to address the growing balance of deferrals because I believe WEPCO has  
3 no financial motivation to address this issue and is, in fact, rewarded by not addressing it.

4 Q. Why do you believe this?

5 A. Utilities defer costs for a variety of reasons. Costs are sometimes deferred, for example,  
6 when there is uncertainty about the amount of a significant cost or when it will occur.  
7 When allowed to defer costs so it can minimize its rate increases, however, a utility does  
8 not have as much incentive to actually control its costs. In addition, it earns a return on  
9 these deferred costs, providing another incentive to keep the deferred costs on its balance  
10 sheet.

11 Large balances of deferred costs are generally not in the best interest of  
12 ratepayers. Costs should generally be recognized as expense in the year they are incurred  
13 in order to match the cost of the item or activity with the benefit the ratepayers get from  
14 it. This is known as the “matching principle” in accounting theory. Deferring costs in a  
15 regulated utility environment interferes with the objective of achieving intergenerational  
16 equity among ratepayers. That is, in a cost-based, regulated environment, it is desirable  
17 for those who benefit from an expenditure be the ones who pay for it. Deferring costs is  
18 a move away from that ratemaking principle.

19 In addition, WEPCO earns a return on these deferred costs, even though they are  
20 generally providing no benefit to ratepayers after the initial period in which the costs  
21 were incurred. At the end of 2016, WEPCO estimates that it will have a total deferral  
22 balance for its electric operations of \$503 million. Of that amount, the company will be  
23 earning the weighted cost of capital on \$201 million and the short-term debt rate on the

1 remaining \$302 million.<sup>4</sup> This results in WEPCO's electric ratepayers paying some level  
2 of carrying costs annually on a half-billion dollars of deferred costs that are generally  
3 providing them no current benefit.

4 Q. Is there any particular deferral that you wish to discuss further?

5 A. Yes, I would like to comment specifically on the transmission escrow. The transmission  
6 escrow was established effective January 1, 2001, for WEPCO, Wisconsin Power and  
7 Light Company, and Wisconsin Public Service Corporation (WPSC) to address the  
8 incremental costs associated with the start-up of the American Transmission Company.<sup>5</sup>  
9 Madison Gas and Electric Company (MGE) was also authorized to defer these costs in its  
10 rate order for the 2001 test year.<sup>6</sup> The order indicated that carrying costs on the deferred  
11 balance would accrue at the weighted cost of capital. The Commission discontinued that  
12 escrow for WEPCO effective December 31, 2007, in docket 5-UR-103 so that no  
13 additional transmission costs were deferred. However, a large balance remained on the  
14 balance sheet awaiting amortization. The Commission then reinstated the transmission  
15 escrow for WEPCO on a temporary basis effective January 1, 2013, in its Final Decision  
16 in docket 5-UR-106, and further indicated that carrying costs on the deferred balance  
17 would accrue at the utility's short-term debt rate. WEPCO interpreted that Final Decision  
18 to mean it could bifurcate the "old" transmission escrow<sup>7</sup> from the "new" transmission  
19 escrow<sup>8</sup> and continue accruing carrying costs on the "old" transmission escrow at the

---

<sup>4</sup> In the last rate case, the Commission determined that WEPCO's short-term debt rate is 0.60 percent. The weighted cost of capital is 7.40 percent and the economic cost of capital is 10.94 percent. (Final Decision, docket 5-UR-107, December 23, 2014).

<sup>5</sup> Final Decision, docket 5-EI-124 (Dec. 22, 2000).

<sup>6</sup> Final Decision, docket 3270-UR-110 (Dec. 21, 2000).

<sup>7</sup> The "old" transmission escrow includes deferred transmission costs that were incurred from 2001 through 2007.

<sup>8</sup> The "new" transmission escrow includes deferred transmission costs that were incurred from January 1, 2013, and going forward.

1 weighted cost of capital. In addition, since the transmission escrow was reinstated  
2 effective January 1, 2013, WEPCO has amortized only its “new” transmission escrow  
3 and intends to continue to amortize only its “new” transmission escrow through the end  
4 of 2016.

5 As of December 31, 2012, WEPCO’s “old” transmission escrow had a balance of  
6 \$114 million. That amount, net of its associated deferred tax, has been earning carrying  
7 costs at the weighted cost of capital and will continue to earn carrying costs at that level  
8 through at least the end of 2016 with no amortization of the balance occurring during that  
9 timeframe. The carrying costs, plus associated income taxes, on the “old” transmission  
10 escrow alone, are costing WEPCO ratepayers approximately \$7.5 million<sup>9</sup> per year on a  
11 total company basis.

12 WEPCO’s “new” transmission escrow is expected to have a balance of  
13 \$239 million at the end of 2016. Thus, the combination of the “old” and “new” escrows  
14 results in total deferred transmission costs of \$353 million by the end of 2016 on an  
15 estimated basis.

16 Since it is the transmission escrow that is driving the growing balance of deferrals  
17 on WEPCO’s balance sheet, I believe it is appropriate to focus on that portion of  
18 WEPCO’s deferred costs in this proceeding.

19 Q. What is the significance of this issue in the context of a proposed acquisition?

20 A. As previously discussed, even before consideration of the parent company taking on  
21 additional debt to fund the acquisition, WEPCO’s electric rates are already high.

---

<sup>9</sup> The amount is calculated as follows: \$114 million times 60% (to get the escrow balance to a net-of-tax basis) times 10.94% (economic cost of capital) = \$7.5 million.

1 To fund the acquisition, Wisconsin Energy Corporation (WEC), the parent  
2 company of WEPCO, is planning to borrow \$1.5 billion of new debt. The money will be  
3 borrowed by the parent company and WEC indicates that it will not use pushdown  
4 accounting. However, the money to service the debt will have to come from the revenue  
5 streams of the utilities<sup>10</sup> and non-utility subsidiaries. To the extent that the cost to service  
6 the parent company's debt is funded by utility dividends, this additional debt will create  
7 greater pressure on earnings at the utility level and on rates. Utilities in Wisconsin have  
8 dividend restrictions and must maintain a certain financial equity ratio, so the dividends  
9 that can be paid to the parent company are limited in part by the amount of net income  
10 that is credited to retained earnings each year.

11 According to the Milwaukee Journal Sentinel, WEC also has been moving to  
12 increase its dividends to stockholders to bring them in line with peer companies in the  
13 utilities sector that pay 65 to 70 percent of their earnings.<sup>11</sup> This will add to the pressure  
14 on utility earnings and, in turn, on rates. All of this pressure on utility rates will make it  
15 even more difficult for WEPCO to address its huge deferral balance.

16 Q. Please explain Ex.-PSC-Kettle-1.

17 A. Ex.-PSC-Kettle-1 shows WEPCO's actual regulatory earnings<sup>12</sup> for the years 2001-2013  
18 compared with authorized earnings. Actual regulatory earnings are shown in Column H  
19 and authorized earnings are shown in Column I. The variance between actual regulatory

---

<sup>10</sup> The revenue streams from the utilities fund dividends up to the parent.

<sup>11</sup> Content, Thomas, "Wisconsin Energy dividend to rise nearly 8%," Milwaukee Journal Sentinel, December 4, 2014.

<sup>12</sup> Regulatory earnings are reported earnings that are adjusted to be on the same basis as authorized earnings. For example, the Commission does not allow rate recovery of charitable contributions, penalties, costs of political activities, promotional advertising, imprudently incurred fuel costs, or bonuses and incentive compensation. Incurred but disallowed costs such as these are added back to the company's reported earnings in order to restate the earnings so that they are on the same basis as authorized earnings. Earnings are also adjusted to remove the effects of non-utility investments such as investment in the American Transmission Company.

1 earnings and authorized earnings is shown in percentages and in thousands of dollars in  
2 Columns J and K, respectively. Column L shows the incremental transmission costs that  
3 were deferred in each year. Cumulatively, over the 2001-2013 time frame, WEPCO has  
4 exceeded its authorized earnings by \$474 million. During the same time period, it  
5 deferred nearly \$128 million of transmission costs.

6 Q. What is your recommendation regarding this issue in the context of this acquisition  
7 application?

8 A. WEC is asking the Commission to approve an acquisition that will require the parent  
9 company to borrow an additional \$1.5 billion in debt. In return, WEC is offering no  
10 immediate rate relief to its customers as a result of the acquisition. At a minimum, it may  
11 be reasonable to condition the acquisition on WEPCO writing off the entire balance of its  
12 “old” transmission escrow that has a balance of \$114 million. The amount to be written  
13 off, net of associated deferred taxes, would be about \$68 million. If the Commission  
14 believes further concessions are appropriate, it could include an additional condition that  
15 WEPCO’s electric operations would earn no carrying costs on its remaining deferred  
16 costs. A condition such as this would reduce WEPCO’s electric revenue requirement in  
17 2016 by about \$11 million per year on a total company basis.

18 Given WEPCO’s more-than-adequate regulatory earnings over the last 13 years, it  
19 may be reasonable to offer something to ratepayers on a going-forward basis that will  
20 address the utility’s growing deferral balance. Directing WEPCO to write off its “old”  
21 transmission escrow balance would provide benefit to ratepayers, would address the  
22 current disincentive for WEPCO to address its growing deferral balance, and would take  
23 some pressure off future rates. If the Commission chooses to also direct WEPCO to not



1           earn carrying costs on its remaining deferred costs, the company would have some  
2           incentive to amortize the remaining deferred costs off its books more quickly.

3    Q.     Does that conclude your direct testimony?

4    A.     Yes, it does.

MJK:jlt:DL: 00952902